LENOX ADVISORS, INC

WEALTH MANAGEMENT ADVISOR

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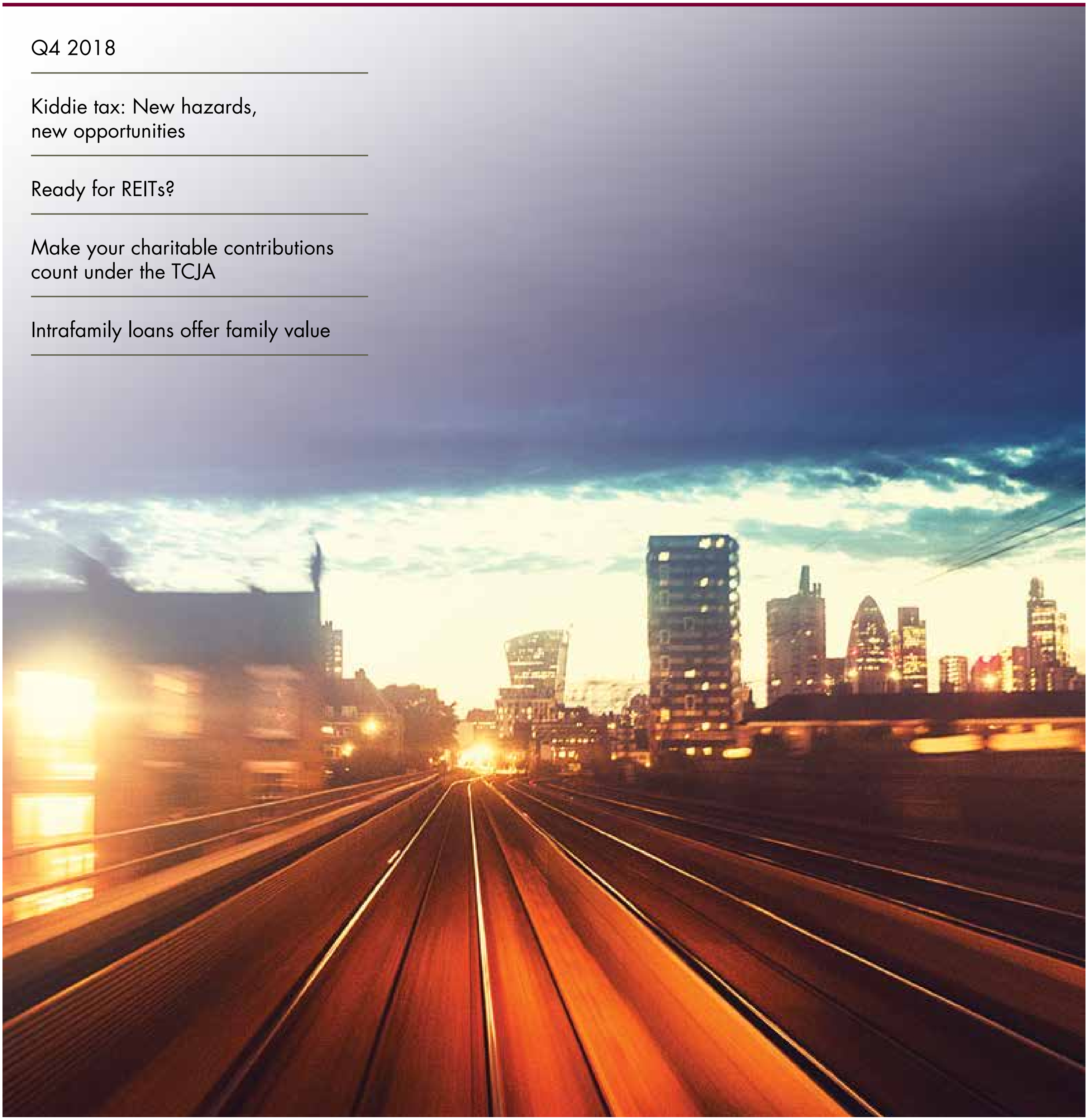
Ready for REITs?

Make your charitable contributions count under the TCJA

Intrafamily loans offer family value



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Kiddie tax: New hazards, new opportunities

Despite its name, the "kiddie tax" is far from child's play. And a recent change made by the Tax Cuts and Jobs Act (TCJA) puts some new adult teeth into the tax. Now, children with unearned income may find themselves in a higher tax bracket than their parents. At the same time, the TCJA creates new opportunities for family income shifting.

INCOME SHIFTING DISCOURAGED

At one time, parents could substantially reduce their families' tax bills by transferring investments or other income-producing assets to their children in lower tax brackets. To discourage this strategy, Congress established the kiddie tax in 1986. The tax essentially eliminated the advantages of income shifting by taxing all but a small portion of a child's unearned income at his or her parents' marginal rate.

When the kiddie tax was first enacted, it applied only to children under 14, but in 2007 Congress raised the age threshold to 19 (24 for full-time students). Note that the kiddie tax doesn't apply to children who reach 19 (or 24, if applicable) by the last day of the tax year. In addition, the tax doesn't apply to children who either 1) are married and file joint returns, or 2) are 18 or older and have earned income that exceeds half of their living expenses.

TAX BITE BIGGER

Starting in 2018, the kiddie tax applies according to the tax brackets for trusts and estates, rather than the parents' marginal rate. In previous years, the kiddie tax essentially undid the benefits of shifting investment income to one's children. By applying the parents' marginal rate to that income, the tax result was about the same as if the parents had retained ownership of the assets. But the TCJA's approach can push children into a higher tax bracket than their parents in many cases. That's because the highest marginal tax rate for trusts and estates — currently, 37% — kicks in when taxable income exceeds $12,500. For individuals, that rate doesn't apply until taxable income reaches $500,000 ($600,000 for joint filers).

Suppose that a married couple filing jointly has taxable income of $250,000 per year, placing them in the 24% tax bracket. If they transfer investments generating $30,000 in ordinary taxable income to their 17-year-old daughter, she is taxed as follows: Assuming she has no earned income, the first $1,050 is tax-free and the next $1,050 is taxed according to the regular individual income tax rate (10%, for a tax of $105). The remaining $27,900 is taxed at the rates for trusts and estates. In 2018, that means the first $2,550 is taxed at 10% ($255 in tax), the next $6,600 is taxed at 24% ($1,584 in tax), the next $3,350 is taxed at 35% ($1,172.50) and the remaining $15,400 is taxed at 37% ($5,698), for a total tax of $8,814.50. Had the parents retained the investments, the tax would have been $7,200 ($30,000 × 24%). In other words, income shifting *increases* the family's tax bill by more than $1,600.

Note that the calculation of the kiddie tax will be different if a child has earned income or if the assets generate long-term capital gains.

PLANNING OPPORTUNITY

Although the new kiddie tax rules can lead to harsh consequences for many families, it may create tax-saving opportunities for higher-income taxpayers. Because the tax is now applied using the progressive rate structure for trusts and estates, rather than the parents' marginal rate, parents can shift a limited amount of investment income to their children at lower tax rates. For example, parents in the 37% tax bracket can shift income up to $14,600 (the $2,100 unearned income threshold plus $12,500) before the 37% rate applies.

There are several ways to shift income to your kids without triggering kiddie tax issues. For example, you can:

- Transfer investments that emphasize capital appreciation over current income, allowing the child to defer income until the kiddie tax no longer applies,
- Transfer tax-deferred savings bonds,
- Transfer tax-exempt municipal bonds,
- Contribute to 529 college savings plans (see "How 529 plan benefits are expanding"), and
- Hire your kids.

Employing your children can be beneficial because earned income isn't subject to kiddie tax; plus, your business can deduct the expense.

LOOK BEFORE LEAPING

Depending on your circumstances, shifting income to your children may reduce your tax bill. But given the risk that income-shifting may increase it, speak with your Lenox Advisor before you attempt this strategy.

HOW 529 PLAN BENEFITS ARE EXPANDING

A 529 college savings plan offers tax-free withdrawals of contributions and earnings used for qualified educational expenses. It's an effective way to fund a child's educational expenses without raising kiddie tax concerns. Here are two reasons:

1. Qualified distributions are tax-free.
2. The plan typically is owned by the parents, not the student — which also provides a financial aid advantage.

Until recently, 529 plans could be used only for higher education expenses. But starting this year, under the Tax Cuts and Jobs Act, you can use a 529 plan to pay elementary and secondary school expenses as well.

Ready for REITs?

Real estate can help diversify your portfolio

The stock market's roller coaster ride earlier this year suggests that the remainder of 2018 is going to be bumpier than previous years. If volatility makes you nervous, it's important to maintain a diversified portfolio that won't plummet in value every time the Dow drops or interest rates tick up. One way to diversify your portfolio is with real estate.

This doesn't mean you need to go out and buy several apartment buildings or commercial properties and become a landlord. There's an easier, possibly less risky way to gain real estate exposure — through real estate investment trusts (REITs).

SPECIAL ENTITIES

It's important to note that REITs don't provide a direct investment in real estate. Instead, a REIT is a special kind of corporation that buys, sells and rents real estate on behalf of its investors. To qualify as a REIT, at least 75% of the company's income must come from real estate. Unlike normal corporations, REITs aren't required to pay taxes at the corporate level. In exchange for this benefit, they must distribute 90% or more of their rental income to shareholders in the form of dividends.

These property companies can be either private or publicly traded. Public REITs are similar to other public equities in that they trade on stock exchanges.

INCOME BOOSTER

Investors traditionally have turned to REITs to diversify their portfolios because they tend to perform differently from bonds and somewhat differently from the broad equity market, while generating long-term returns comparable to those of the latter. That said, the correlation between REITs and U.S. stocks has increased in recent years, which means that REITs may no longer provide quite the same diversification opportunities as in the past.

Many investors favor REITs for the securities' relatively large income stream. Individuals approaching retirement may look to REITs' dividends as a source of regular income. (But bear in mind that there is no guarantee that a REIT will distribute a dividend.) Liquidity is another important benefit, as REIT shares can be bought and sold on public markets. What's more, REITs give you flexibility to achieve your target real estate exposure because you can own the exact amount that fits your investment strategy.

There are, of course, drawbacks. For example, REIT dividends are taxed as ordinary income, which is subject to a higher rate than qualified stock dividends. One way to limit REITs' tax impact is to hold them in an IRA, 401(k) plan or other tax-advantaged investment account.

LEVELS OF DIVERSIFICATION

You can invest in publicly traded REITs in two ways — by buying shares of individual real estate companies or a REIT-oriented mutual fund. The main difference between the two is the level of diversification. While individual REITs own multiple properties, some of these companies specialize in only one or two types of real estate. Industrial REITs, for example, generally focus on warehouses, while health care REITs might emphasize only medical facilities.

This is fine if you're looking for targeted exposure to one segment of the real estate universe. But if broader diversification is your goal, you may be better served by an investment that owns many kinds of REITs and gives you broader exposure to the real estate asset class.

WEIGH YOUR OPTIONS

A rising interest rate environment can put a damper on REITs because higher rates raise borrowing costs. They also can make safer income-oriented investments, such as money market accounts, seem more attractive by comparison. However, REITs have a relatively low performance correlation to equities. So, when the stock market plunges, REITs may not dip as much, providing something of a hedge in an otherwise stock-heavy portfolio.

There's no guarantee that REITs will appreciate in value or pay dividends. Also, it's possible to lose money in such investments. Talk to your Lenox Advisor about whether REITs can benefit your portfolio given your personal circumstances, long-term goals and risk tolerance.

Make your charitable contributions count under the TCJA

The Tax Cuts and Jobs Act (TCJA) will likely reduce the tax benefits of your charitable contributions. However, that doesn't mean you should stop giving or reduce the size of your gifts. After all, the availability of tax deductions isn't the reason you give. But it does affect the after-tax cost of charity. So it's important to incorporate tax considerations into your charitable giving plan.

PRICE OF CHARITY

The after-tax cost of a charitable contribution is the amount of the gift less the tax you would have paid on that amount if it weren't for the

charitable deduction. For example, Ian and Eileen, a married couple filing jointly, had $300,000 in taxable income in 2017. This placed them in the 33% tax bracket. If they donated $30,000 to charity in 2017 (and assuming they itemized their deductions), the after-tax cost would be $20,100. However, in 2018 the same amount of taxable income would place Ian and Eileen in the 24% bracket, so the after-tax cost of a $30,000 charitable contribution would increase to $22,800.

The TCJA also reduces the tax benefits of charitable giving by nearly doubling the standard deduction to $12,000 for single filers and $24,000 for joint filers and limiting itemized deductions. Under the law, the itemized deductions left are mortgage interest (now limited

to interest on up to $750,000 in acquisition debt for newly purchased homes), state and local taxes (capped at $10,000), medical expenses and charitable contributions. Because of these changes, a substantially greater number of taxpayers are likely to take the standard deduction, which provides no tax incentive for charitable giving.

One change that does boost the benefits of charitable giving for a limited number of taxpayers is a higher annual limit on gifts to public charities and certain foundations — from 50% to 60% of adjusted gross income (AGI). As before, other types of contributions are limited to 50%, 30% or 20% of AGI and disallowed contributions may be carried forward for up to five years.

STRATEGIES TO CONSIDER

Suppose you're a joint filer with $10,000-plus in state and local taxes, $7,500 in deductible mortgage interest, $5,000 in charitable contributions and no deductible medical expenses in 2018. Since these deductions total $22,500, you're better off taking the $24,000 standard deduction, so your charitable contributions generate no tax benefits. A potential strategy for increasing your tax benefits is to "bunch" your contributions into alternating years. For example, instead of contributing $5,000 per year to charity, you might contribute nothing this year and $10,000 next year. That way, you would take the standard deduction in 2018 and $27,500 in itemized deductions in 2019. This would increase your total deductions by $3,500 for the two-year period.

If you're 70½ or older, another possible strategy is to make a qualified charitable distribution (QCD) from an IRA. The tax code permits you to transfer up to $100,000 per year tax-free directly from your IRA to a qualified charity and to apply that amount toward your required minimum distributions for the year. Because the distribution isn't included in your income, you don't have to pay tax on the amount and it lowers the odds that you'll be affected by unfavorable adjusted gross income rules. If you itemize deductions, this may provide little or no additional benefit, but if you don't itemize, it's a powerful planning tool.

REVIEW YOUR PLAN

If you're philanthropically inclined, be sure to evaluate the impact of the TCJA on your charitable giving plan. If the act will substantially increase the cost of your charitable gifts, consider adjusting the size of your gifts or implementing strategies that will increase your charitable deductions.

Please note that legislation has been introduced in Congress that would allow taxpayers to deduct contributions even if they don't itemize deductions. The proposed law would also eliminate the current caps on charitable contribution deductions. Please contact your Lenox Advisor for information about the proposal and its current status.

Intrafamily loans offer family value

When children or other family members need financial assistance, it may be tempting to simply hand them a check. But *lending* — rather than *giving* — money to your loved ones offers several advantages.

COUNT THE BENEFITS

Why might loans be better than gifts? For starters, if you're concerned about whether you'll be able to save enough for a comfortable retirement, lending allows you to help family members without losing the funds permanently. Also, loans can help teach financial responsibility. If you feel that your children — or even adult family members — aren't as prudent with their money as you'd wish, a regular repayment schedule may instill the kind of discipline they need.

Also, if you're concerned about estate taxes, intrafamily loans can be an effective vehicle for transferring wealth tax-free. The amount by which the borrower's investment returns exceed the interest paid on the loan is essentially a tax-free gift.

The recently enacted Tax Cuts and Jobs Act (TCJA) doubled the estate, gift and generation-skipping transfer (GST) tax exemptions to $11.18 million ($22.36 million for married couples), so only a much smaller group of families are subject to these taxes. Nevertheless, intrafamily loans may still make sense. Exemption amounts are scheduled to revert to their pre-TCJA levels in 2026, and there's no guarantee Congress won't reduce them even further in the future. Intrafamily loans and other estate planning vehicles can help protect your wealth against future transfer taxes by preserving your exemptions.

MAKE IT OFFICIAL

To avoid unwelcome tax consequences, you'll need to structure your intrafamily loan as a legitimate, arm's-length transaction. Most important, charge interest at or above the current applicable federal rate (AFR). Otherwise, you'll be subject to income tax on imputed interest — the excess of the AFR over any interest you actually collect. Imputed interest also may be treated as a taxable gift to your borrower.

In addition, you should:

- Memorialize the loan with a promissory note,
- Establish a fixed repayment schedule,
- Ensure that the loan is actually repaid when due, and
- Obtain adequate collateral or other security, if possible.

In other words, treat your intrafamily loan like a loan to a stranger.

BANK ON IT

Finally, to ensure the desired tax treatment of intrafamily loans, affluent families might consider establishing a "family bank." This is a family-funded entity, such as a trust or limited partnership, designed to make loans to family members. By "professionalizing" the lending process, a family bank can help ensure that loans satisfy IRS requirements and meet lending objectives.